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Regions Financial Corp. (RF)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Regions Financial Corporation's Quarterly Earnings Call. My name is Jennifer, and I'll be your operator for today's call. I would like to remind everyone that all participants' phone lines have been placed on listen-only. At the end of the call, there will be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Dana Nolan to begin again.

Dana W. Nolan

Executive Vice President-Head of Investor Relations, Regions Financial Corp.

Thank you, Jennifer. Welcome to Regions' Third Quarter 2018 Earnings Conference Call. John Turner will provide highlights of our financial performance, and David Turner will take you through an overview of the quarter. A copy of the slide presentation as well as our earnings release and earnings supplement are available under the Investor Relations section of regions.com.

Our forward-looking statements disclosure and non-GAAP reconciliation are included in the appendix of today's presentation and within our SEC filings. These cover our presentation materials, prepared comments, as well as the question-and-answer segment of today's call.

With that, I will turn the call over to John.

John M. Turner, Jr.

President & Chief Executive Officer, Regions Financial Corp.

Thank you, Dana. Good morning and thanks for joining our call today.

Before we get started I want to take a moment to speak about Hurricane Michael. As we've seen, this was an incredibly powerful storm and communities in the Florida Panhandle, South Alabama, and South Georgia all faced different challenges as they begin the recovery process. I'm extremely proud of the way our teams are responding to meet the needs of customers, fellow associates, and communities affected. As of today all of our associates are safe and accounted for. All but five of our branches in the impacted areas are open and conducting business, and all of our ATMs are now operating.

We're working with our customers to determine their needs for assistance and have activated disaster recovery financial services, including ATM fee waivers and loan payment deferrals. I was in Panama City on Friday and while the damage is significant, the markets are determined to come back strong. We're still evaluating the overall financial impact to Regions, but we do not expect it to be material.

With respect to the third quarter, we're very pleased with our financial performance. We reported earnings from continuing operations of $354 million, reflecting an increase of 20% compared to the third quarter of the prior year. Importantly, we grew loans, fees and households, and delivered positive operating leverage, and significantly improved efficiency.

Of note, adjusted pre-tax pre-provision income increased again this quarter to its highest level in over a decade. It's important to point out that our results include the impact of a $60 million contribution to our foundation during

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the quarter. Combined with a $40 million contribution we made in December of 2017, we've now invested $100 million, effectively positioning the foundation to provide consistent and sustained investments in our communities for many years to come.

Our third quarter performance clearly demonstrates our focus on continuous improvement is gaining traction. We remain committed to the successful execution of our Simplify and Grow strategic priority, and investments in technology, process improvements and talent are paying off.

In terms of the economic backdrop, we remain encouraged by current conditions and customer sentiment. Increased lending activity coupled with substantial completion of portfolio recycling and reshaping efforts allow us to deliver broad-based loan growth this quarter.

As we look to the fourth quarter, pipelines remain healthy, and we're on track to achieve our low-single digit adjusted average loan growth for the year.

Let me quickly remind you of the four key strengths we believe provide considerable momentum for Regions.

First, is our asset sensitivity and funding advantage driven by our low cost and loyal deposit base. This continues to provide significant franchise value and a competitive advantage, particularly in a rising rate environment.

Second relates to asset quality. We believe that derisking and portfolio reshaping activities we have completed, combined with our sound risk management practices, have positioned us well for the next credit cycle.

Third, our capital position supports prudent growth and investments as well as additional capital returns.

And finally, we expect additional improvements in core performance through our Simplify and Grow strategic priority, which is well underway.

Again, our goal is to generate consistent and sustainable long-term performance. And we believe our results this quarter provide tangible evidence that our focus on continuous improvement is working. With that, I'll now turn it over to David.

David J. Turner, Jr.

Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Thank you, John, and good morning.

Let's begin on slide 4 with average loans. Adjusted average loans increased almost 2% over the prior quarter, driven by broad based growth across the consumer and business lending portfolios. New and renewed loan production remained solid, while previous headwinds associated with portfolio reshaping efforts subsided. In addition, recently implemented process redesign and improvement efforts focused on accelerating commercial credit decisioning also aided loan growth.

All three businesses within our corporate banking group, which includes corporate, middle market commercial, and real estate, experienced loan growth across our geographic markets. Average loan growth was led by C&I across many sectors, particularly within our specialized lending and also within middle market commercial businesses.

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The investor real estate portfolio reversed trend and contributed modest average loan growth, driven primarily by growth in term real estate lending. Further, owner-occupied commercial real estate loans appear to have reached an inflection point as average loan balances remained relatively stable in the quarter.

Consumer lending produced consistent loan growth across most categories, led again this quarter by our point-of-sale partnerships as well as solid increases in residential mortgage, indirect-vehicle and consumer credit card lending.

Let's move on to deposits. We continue to execute a deliberate strategy to optimize our deposit base by focusing on growing low-cost consumer and relationship-based business services deposits, while reducing certain higher-cost retail brokered and trust collateralized sweep deposits.

Total average deposits declined 1% compared to the second quarter and 3% compared to the prior year. The linked quarter decline was primarily attributable to seasonal decreases, whereas the year-over-year decline was primarily attributable to strategic reductions as well as corporate customers continuing to use liquidity to pay down debt or invest in their businesses.

Importantly, our teams continue to successfully grow net new consumer checking accounts, households, wealth relationships and corporate customers. For the full year, we continue to expect relatively stable average deposit balances, excluding retail brokered and wealth institutional services deposits.

During the third quarter, interest-bearing deposit cost increased 6 basis points and total deposit costs increased only 3 basis points. Cumulative deposit betas through the current rising rate cycle remain low at 15%. Year-to-date deposit betas were 23%, and we anticipate modest increases in the fourth quarter.

While we expect deposit betas to increase, we continue to believe our large retail deposit franchise differentiates us in the marketplace and positions us to maintain a lower deposit beta relative to peers.

Now let's look at how this impacted our results. Net interest income increased 2% over the prior quarter, and net interest margin increased 1 basis point to 3.50%. Both net interest income and margin benefited from higher market interest rates, partially offset by increased wholesale funding, which included expense associated with debt issued during the quarter. Net interest income also benefited from higher average loan balances.

Looking to the fourth quarter, recent loan growth, the high likelihood of another rate increase in December, and an expectation for a modest increase in deposit costs should result in a continuation of recent growth trends in net interest income, and a 3 basis point to 5 basis point expansion of net interest margin, putting us solidly within our 5% to 6% NII growth expectations for the year.

We also experienced a good quarter as it relates to fee revenue. Adjusted noninterest income increased 1% from the second quarter as increases in service charges, market value adjustments on employee benefit assets, and other noninterest income were partially offset by decreases in capital markets and mortgage income. The increase in other noninterest income was primarily attributable to a net $5 million increase in the value of certain equity investments and a $2 million net gain on the sale of low income housing tax credit investments. Other noninterest income also benefited from a $4 million decrease in operating lease impairment charges. For the full year, we continue to expect adjusted noninterest income growth between 4.5% to 5.5%.

Let's move on to expenses. On an adjusted basis, noninterest expense decreased 3% compared to the second quarter. Most expense categories reflected a modest reduction in the quarter with the primary contributors being a

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reduction in salaries and benefits and lower expense associated with Visa Class B shares sold in a prior year. The adjusted efficiency ratio improved to approximately 230 basis points this quarter to 58.1% and through the first nine months of 2018 is 59.7% below our full year target. Also through the first nine months of 2018, we generated adjusted positive operating leverage of 3.4%. For the full year, we continue to expect adjusted positive operating leverage of 3.5% to 4.5% and relatively stable adjusted expenses.

The third quarter effective tax rate was 18.7% and was favorably impacted by retrospective tax accounting method changes finalized in the quarter. Our full year effective tax rate expectation remains unchanged at approximately 21%.

Let's shift to asset quality. Overall, asset quality remained stable during the third quarter. Total nonperforming loans excluding loans held for sale decreased to 0.66% of loans outstanding, the lowest level in over 10 years. And business services classified loans decreased 7%. Business services criticized loans, as well as total troubled debt restructured and past due loans increased modestly.

Net charge-offs increased 8 basis points to 0.40% of average loans. The provision for loan losses approximated net charge-offs and the resulting allowance totaled 1.03% of total loans and 156% of total non-accrual loans. While overall asset quality remains benign, volatility in certain credit metrics can be expected. Through the first nine months of 2018, net charge-offs totaled 38 basis points. With respect to the full year, we continue to expect net charge-offs to be towards lower end of our 35 basis points to 50 basis point range.

Some brief comments related to capital and liquidity. Through open-market purchases and our previously disclosed accelerated share repurchase agreement, we repurchased approximately 60 million shares of common stock during the third quarter. We also completed the sale of our Regions Insurance subsidiary. The resulting after-tax gain was $196 million and is reflected as a component of discontinued operations. Regarding 2018 expectations, our full-year expectations, which we updated in mid-September remain unchanged. They are summarized on the slide for your reference.

So, a quick summary. We are very pleased with our third quarter results, believe we are on track to achieve our 2018 expectations, and have good momentum as we head into 2019 and beyond. With that, we're happy to take your questions, but do ask that you limit them to one primary and one follow-up question. We will now open the line for your questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. The floor is now open for questions. [Operator Instructions] Your first question comes from the line of John Pancari with Evercore ISI.

John Pancari
Analyst, Evercore Group LLC

Q

Good morning.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Good morning.

John Pancari
Analyst, Evercore Group LLC

Q

Just on the expense side, I want to talk a little bit more about the efficiency ratio. I know you're currently in the 58% range, and you're expecting still below 60% for the full year of 2018. When you look at 2019, just given your expense efforts, but also some of the momentum you have on the top line, where do you think that can go? And then longer term, do you think mid-50s is still an appropriate goal beyond that? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Hey, John. This is David. Yeah. So we had a nice improvement in our efficiency ratio in the quarter. We continue to expect our efficiency ratio will improve throughout the year and into 2019. We had mentioned that we thought getting into the mid-50s was a reasonable goal for us over time, helped in part by our efficiency efforts, continuous improvement, and lift in revenue from rates and the efforts we have to grow revenue through our investment. So, we still believe mid-50s at this point is a good target. Over time, maybe we get below that but we're going to update all of that for you in February, specifically.

John Pancari
Analyst, Evercore Group LLC

Q

Okay. All right, thanks. And then separately on the loan growth side, want to get a little bit more thoughts, a little bit more color on where you're seeing the strongest demand and – because we are hearing that a good number of the banks flagged that pay-downs were still relatively elevated and they're impacting their growth outlooks, while others are also flagging the competitive backdrop and lowering their guidance given the competitive dynamics. It doesn't seem that you're seeing that in a profound way. And so wanted to get some of the color you have around those factors. Thanks.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. John, this is John. I would say, we continue to remain optimistic about our ability to deliver on our commitment to low-single digit loan growth on an adjusted basis. Loan growth was pretty broad based particularly within the wholesale business this quarter. Saw about, if you adjust for the runoff in dealer indirect, about 1% growth in consumer and almost 2% in the wholesale book.

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We're not facing the headwinds that we had been facing that were the result primarily of our own derisking activities. So, we predicted that we would likely hit a bottom in investor real estate sometime in the second quarter. We did. And we began to see a little pickup in activity there. And so grew a little in the second quarter. And that growth continued into third quarter.

Similarly, within our commercial banking activities and corporate banking, the growth has been broad-based across our specialized industries groups, our diversified industries teams, manufacturing, distribution, and across our geographies.

I would tell you it is very competitive. Despite the fact that we grew, we passed on about half as much business as we actually produced. And the reason we passed was primarily because of pricing or some other structural element.

We didn't experience the pay-downs in the third quarter that others have talked about, but we very much did in the first and second quarter of this year. And you might remember in the third and fourth quarter of 2017.

So I'd say it is very competitive. Competition comes from a variety of sources. But we have really solid pipelines and feel good about our ability to deliver on low-single digit adjusted loan growth for the year.

John Pancari
Analyst, Evercore Group LLC

Q

Okay. And one more thing, could that low-single digits move up to the mid-single as you think about 2019?

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

We're still committed to low-single digit loan growth, John. And we think it's important to be very disciplined, to be very prudent about what we booked, focus on client selectivity and risk adjusted returns. We don't need a lot of loan growth to achieve our stated objectives. And so we're going to be careful and thoughtful about what we book. And so our targets are still low-single digit at this point.

John Pancari
Analyst, Evercore Group LLC

Q

Got it. All right. Thank you.

Operator: Your next question comes from the line of Matt O'Connor with Deutsche Bank.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Good morning.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Morning.

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David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Morning.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

You guys used a lot of your 2018 CCAR approval of buybacks this quarter, but your capital levels are still high. And obviously, the market is selling off overall here including your stock. And just wondering about thoughts in terms of going back, asking for more? And how aggressive you could be on that front?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, Matt. So we have our targeted capital range that we've espoused before and Common Equity Tier 1 in that 9.5%. We've been working towards that. And as you know, when you file a CCAR plan that we did, didn't receive an objection. It had timing built into that as to when we would buy those shares back as well as have our dividend increase.

So in order to change that, we would have to have a resubmission. We think we're on a good glide path right now, given where we are. We made a lot of progress this quarter. As you laid out, our repurchase program will be completed in the fourth quarter. And we can be in the market executing on our next quarter plan after earning – our accelerated share repurchase program I was referring to.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. When you say your repurchase program completed in 4Q, you're talking about the ASR or your...

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. Yeah. I want to clarify. So the component part of the program, there's a piece of it that's an accelerated share repurchase program. Will be completed in the fourth quarter, and we have other repurchases that are baked in to our CCAR submission after that.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. And then just the thoughts on the 9.5% CET1 target, like I feel like kind of was set maybe a couple years ago. And it seems like some of your peers have been guiding to hopefully getting into the, call it, 8% to 9% range.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. Well, I think our peers are really all over the board. For us, it's incumbent upon us to keep the amount of capital we think we need to run our business.

And we will continue to update that each year and challenge ourselves. But we also have to be cognizant of where we are. We're nine years into an expansion. Next May will be 10 years.

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And we think given our risk profile, where we are, and considering all other things, a 9.5% common equity Tier 1 is proper for us at this time. That being said, we'll be looking at that as we wrap up this year and into the first quarter. And we'll make any adjustments we deem appropriate at that time.

Matthew O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thank you.

Operator: Your next question comes from the line of Erika Najarian with Bank of America.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Yes, good morning. Thank you. My first question is, thank you for reminding us about your deposit base. And as we think about further rate hikes from here, how should we think about the stickiness of your interest-free deposit balances? And I'm wondering if you could help us get a sense of the $35 billion in average interest-free deposit balance, how much of that would you call operational or part of checking accounts that are less vulnerable to mix shift?

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah, Erika, maybe I'll start. This is John. I would say to the question of how – what percentage of our deposit balances we think are operational; 67% of all of our deposits are consumer deposits. We think approximately 93% of all of our consumer households maintain some sort of operating account balance with us, obviously on the wholesale side, our corporate bank, all of those deposits that sit in demand deposits, we think of as being operational. So I would believe that the vast majority of our demand deposits are in fact operational in nature.

When you look at our consumer book, one of the things that gives us a lot of confidence about our deposit gathering franchise and the strength of our customer base is that over the last year, we've actually grown consumer demand by over 5%, we've grown consumer savings by about 7.3%, and grown NOW deposits by over 1%. So despite the fact that we've been aggressively managing our interest costs, the core of our business which is consumer operating deposits has continued to grow as have checking accounts through the last 12 months.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Erika, I'll add, the noninterest-bearing from a corporate standpoint as we mentioned in the prepared comments, we did see companies utilize their excess liquidity to pay down debt to make fixed capital investments and in some cases seek higher yields than we were willing to pay. And so, we're not losing the customer. They're just choosing to seek the highest return as you would expect all treasurers to do. So, we think we have the ability to really gather deposits. We're looking at loan growth. We want to pare that off, and our commitment is to grow our deposit base, our core deposit base commensurate with our loans over time. You may have a mismatch in a given quarter, but we feel good about where we are in terms of deposit growth looking forward.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. And just as a follow-up to John's line of questioning. John, I was interested in, when you answered the question about the amount of business that you passed on over during the quarter, and I'm wondering if you could

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give us a sense, this has been much talked about this quarter, on the level of non-bank competition that you're experiencing. And perhaps, David, if you could give us a sense of any residual exposure on balance sheet to leverage lending or sponsor-backed term facilities?

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. So, we're seeing competition from non-banks in the real estate mortgage space, so commercial real estate mortgage space from life insurance companies, and commercial banking activities largely around M&A, sponsor-based transactions from business development corporations, private equity-backed funds. And that is having some impact on our business. But as I said to John, the impact was more significant in the first part of the year, particularly in quarter one in parts of quarter two, particularly with respect to the commercial mortgage business. On an ongoing basis, we continue to see private equity-backed funds take more risk in the leverage space than we're willing to take.

And as a consequence, we would think that – or suggest that our exposure to leverage lending and to sponsor-backed transactions is very reasonable at about 20% of our leverage exposure down from over 35% about a year ago. So we've continued to reduce our exposure to sponsor-based leverage loans, and in part that's a function of risk selection and I think in part a reflection of just their activity in the marketplace.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. Thank you.

Operator: Your next question comes from the line of Geoffrey Elliott with Autonomous Research.

Geoffrey Elliott
Analyst, Autonomous Research LLP

Q

Good morning. Thanks for taking the question. The other consumer indirect bucket continues to be a helpful driver of growth. Can you maybe start just remind us what's in that and what's been driving the growth there?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Sure. So we have indirect coming from a couple of different places. We have indirect auto. And then we have indirect other which is our point-of-sale initiative that we have with several entities. We continue to experience good growth there and good economics on that portfolio. We continue to challenge ourselves on all of our portfolios. The profitability on indirect auto has been challenged. We're a prime, super prime book and all the losses are improved. The economics there have been challenging and we're continuing to look at that. Yields are growing a bit for us there. So those are really the two kind of point-of-sale and indirect auto are the two big categories Geoff.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. I would just add, we got into that business to – because we've began to see consumer preferences develop and evolve. We wanted to learn largely what was going on in that space. We've established some internal concentration limits to manage our exposure to effectively consumer indirect unsecured lending. I think it's to-date

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been good for us. As David suggested, the credit quality has been good, returns have been good, and we've learned some things through observation, and grown the balance sheet a little bit.

Geoffrey Elliott
Analyst, Autonomous Research LLP

Q

Thanks. It looks like it's been a pretty important driver of the NII growth. On those concentration limit, how much are you willing to see the portfolio grow?

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

I don't recall that we have necessarily been public about limits we've established, but we don't expect the portfolio to grow a whole lot more than its current size.

Geoffrey Elliott
Analyst, Autonomous Research LLP

Q

Great. Thanks very much.

Operator: Your next question comes from the line of Ken Usdin with Jefferies.

Ken Usdin
Analyst, Jefferies LLC

Q

Thanks, good morning, guys. First question, just to follow-up on the liability side. David, you said you issued that debt this quarter and you had some ins and outs about deposits that led to a little bit more on the FHLBs which might happen quarter-to-quarter. But I'm just wondering in terms of the structure of the liability side and the capital stack, where are you in terms of the efficiency of the right side of the balance sheet in terms of that mix of long-term debt, how much more you would be issuing naturally over time and whether preferreds become a more likelihood as that capital ratio grows into itself? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yes, Ken. So, we did that we're opportunistic with regards to our $1.5 billion that we raised recently, some in the holding company and some in the bank to take advantage of FDIC cost. As we look out at our plan for the holding company, we'll have another debt issuance in the holding company probably in the first quarter and that number will be in the $500 million range. From a preferred standpoint, there are a lot of moving targets in terms of preferred. We need to see what happens from a capital standpoint. We have a lot going on with the regulators and we need to see what happens with the buffer in terms of whether or not we need to issue and how much and when. So you need to stay tuned a little bit on the preferred offering, which may or may not occur in the second half of the year if it occurs.

Ken Usdin
Analyst, Jefferies LLC

Q

Understood. Okay. And then my follow-up is just on coming back to the left side of the balance sheet and the mix of earning assets, you've kept the investment portfolio up pretty stable here for a bit now, now that the loans have started to churn up. Can you just talk about what you're doing in the investment portfolio, what your kind of front book, back book looks like, and are you comfortable with the size of it at this point?

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David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, let me talk more about the total left side of the balance sheets. So our securities book, we feel good about where that is. Obviously, we want to comply with LCR to the extent some of that gets changed regulatorily. Maybe we can put certain of those investment securities in a little healthier return than some of the securities we have today, Ginnie Mae securities, as an example. But in terms of front book, back book, we have about $14 billion of assets that are repricing over the next 12 months, that repricing of securities and loans and that's a pick-up of the 75 basis points to 100 basis points even if rates don't move. If rates stay right where they are now right now, and that's a pretty good tailwind to us from an NII growth and resulting margin. And it's why we've been able to give you the confidence that we could hit our NII growth goals for this year and of course we'll update those for next year later on. But, that's important to note.

Ken Usdin
Analyst, Jefferies LLC

Q

All right. Thanks for that, David.

Operator: Your next question comes from the line of Saul Martinez with UBS.

Saul Martinez
Analyst, UBS Securities LLC

Q

Hi. Good morning, everybody. Just on credit quality, obviously 40 basis points is still very – oh you did see a bit of an uptick, but still within sort of the guidance range. But can you give us any color on the uptick and any areas of your portfolio you just feel may have more risk than others? Just a general view on where you think credit quality is heading?

Barbara I. Godin
Senior Executive Vice President & Chief Credit Officer, Regions Financial Corp.

A

Yeah. So it's Barb Godin. Relative to the uptick, it was related really to two credits. Nothing systemic in the portfolio that we see, but two credits drove that uptick.

And for the rest of the portfolio, it was well-behaved, remained in good condition, moving in the right direction. And as we think about the future in terms of fourth quarter as well, we don't see anything major on the horizon. And again, feel good about our guidance of 35 basis points to 50 basis points. And as you mentioned, 40 basis points is still right there in the middle of our guidance.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. And I would just add, when you look at our overall credit metrics, we continue to see improvement in the level of classified assets, the level of non-performing loans. There's a little uptick in criticized loans this quarter that, to Barb's point, does not reflect anything systemic at all. And all the results reflect the outcome of the recent SNC exam.

Saul Martinez
Analyst, UBS Securities LLC

Q

Okay. Got it. If I could just sort of stay on the theme of credit quality. I know you guys have been critical of certain aspects of CECL. But where are you? Can you just give a sense where you are in terms of your preparation?

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When do you think – assuming there are no fundamental changes to how CECL works, when do you think you'll have a rough estimate of what the financial impact could be?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. Saul, this is David. So we've been – we've spent an awful lot of time and effort on our modeling and leveraging some of the CCAR models and building some new ones. We're in pretty good shape. We're leveraging third parties to make sure we do this right.

And we'll be running parallel. We'll start that in 2019. We'll adjust and learn so that we're prepared for January 2020.

As you know, there are discussions on CECL and whether or not there may or may not be modifications to the standard, whether or not there may be a delay or not, we'll just have to see. But it's incumbent upon us to be prepared either way.

And as far as when we'll be prepared to give that guidance, we really – before we do that, we want to make sure our models are reflective of our best numbers we can come up with. So it'll be into 2019, probably no earlier than the middle of the year. And we'll just have to see how things develop before we can give you that kind of guidance.

Saul Martinez
Analyst, UBS Securities LLC

Q

Okay, got it. Thanks a lot.

Operator: Your next question comes from line of Betsy Graseck with Morgan Stanley.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Hi, good morning.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Morning.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Could we talk a little bit on the expense side? I know in the prepared remarks you highlighted the operating leverage and the outlook, but maybe you could give us a sense of the drivers? And if this is going to be taking place in the near-term due to Simplify and Grow? Or is this something that is a little bit longer tailed with regard to acceleration operating leverage?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, Betsy. So there are several things working on operating leverage and efficiency, the revenue side and the expense side.

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Let me start with revenue. We continue to make investments to grow revenue. Those investments are in people and in technology, making investments in higher growth markets through new branches.

And we need to pay for those investments. And so we've been leveraging our continuous improvement process, that we started out with Simplify and Grow. It's going to continue. This is something we want to culturally embed is, how do we get better each and every day through process improvement and leveraging technology?

A big part of the expense side has been savings in the S&B line item that you saw this past quarter, which we told you about beginning of the year that you would see the benefits of that in the third quarter. You'd see it again in the fourth quarter.

We're substantially through with the larger numbers of head count reductions. You'll see some. But not to the degree that you saw thus far through the nine months of September.

And then from there, we have to continue to become more efficient. And it gets back to John's earlier comment on the efficiency ratio, where you think you can go. I just think our industry will continue to become more efficient in leveraging all the new technologies that are out there to get an efficiency ratio, which we think we could target in the mid-50s. We'll see if we can get better than that over time.

But that, with a healthy revenue growth and making investments to grow our business are really important to us.

Betsy L. Graseck Q
Analyst, Morgan Stanley & Co. LLC

And then just on the NIM outlook, I know we talked through some of the drivers including securities book. Can you give us a sense as to how sticky you think that uplift that you're looking for in 4Q can persist going forward?

David J. Turner, Jr. A
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Well, our margin of 3.50% is better than most of our peers. And so it gets harder as you have a – as you continue to outperform it gets harder to keep outperforming. That being said, we are leveraging what we see as our competitive deposit base, continue to make investments to grow earning assets in particular the loan portfolio as you saw this quarter. So, leveraging off that and the future growth that we see should help us. And obviously, we think December has a pretty high probability of a rate increase in that. And so if LIBOR starts moving 30 days prior to December rate increase and you'll see that benefit even more. Our beta has outperformed and we do expect our beta to get higher, to continue to increase, the pace of which we'll see what happens for the year, we're only cycled to-date about 15%. So, we think that continues to increase. That is baked into our guidance already that we've given you, and we think that continues to help propel us to continuing to grow NII in the fourth quarter and into 2019.

Betsy L. Graseck Q
Analyst, Morgan Stanley & Co. LLC

Okay. And LIBOR-OIS has actually widened a little bit recently. So maybe that's a tailwind into 4Q, or are you already had that baked into your 4Q outlook?

David J. Turner, Jr. A
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

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We have that. We have that baked in already.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Thank you.

Operator: Your next question comes from the line of Gerard Cassidy with RBC.

Gerard Cassidy
Analyst, RBC Capital Markets LLC
Q

Thank you. Good morning, David. Good morning, John.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.
A

Good morning, Gerard.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Good morning, Gerard.

Gerard Cassidy
Analyst, RBC Capital Markets LLC
Q

Can you guys share with us, when we go back and look at your numbers as well as your peers for the last 20 years on non-interest-bearing deposits to total deposits, the industry and yourself included have seen a significant increase in that percentage. In fact, with you guys and post the merger, of course, it looks like it was running around 19%, 20% right around that time in 2007, 2008. Now, it's obviously in the mid-30s. I think it was 38% this quarter. Is there something structurally different with the customers that they keep – that you're able to garner much more of your deposits in noninterest-bearing?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

So Gerard, we have really focused on continuing to grow customer accounts, demand deposit, checking accounts. We've been very good at that and we've grown checking accounts this year about 1.5%. And so we think that that will continue. We expect that to continue, our noninterest bearing demand deposits have also grown over time. We have seen that shrink as have all of our peers this past quarter. We performed a little better than most. And again, that's because we see large companies putting that noninterest-bearing to work either to pay down debt, make fixed capital investments or reinvest in some higher earning securities.

We do think that the noninterest-bearing will be higher than history. We think as companies have gone through the liquidity scare that we had in 2008 that people are thinking differently about their liquidity. We think – we'll see if we're right, but we think people will hold on to more of that liquidity and leverage up versus using it all and then leveraging. At least that's our assumption. We'll see how that plays out, but I think it's going back to that liquidity scare in 2008, it's a little bit of a change in terms of how people think about it.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.
A

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Yeah. I'd agree with that, Gerard. I'd also offer – I mentioned 67% of our deposits are consumer deposits and 93% of our consumer households have a primary operating – what we would consider a quality primary operating account with us. The average balances in our deposit accounts are more granular we think than some of our peers, reflects the markets that we're in reflects the type customers that we're banking and we think that that's a competitive advantage. It in fact does result in our maintaining more demand deposits let's say in the consumer space in some regard than we did before and it is a real strength of our franchise.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Very good. And then on the other side of the balance sheet, you guys have been very frank and candid about what happened to the investor real estate portfolio post the financial crisis and the recession. And you've been clear about winding it down to a level that you're comfortable with, which seems, as you pointed out, the inflection point might be this quarter. So as we move forward, what type of projects are you guys looking at on the investor real estate whether it's the construction projects or the investor real estate mortgage area? And I think, John, you said you didn't really give any guidance on how big you'd allow different portfolios to grow to as a percentage of total portfolio. But in this one, I don't know if you'd be willing to disclose how big you would allow this one to grow to again as a percentage of the total portfolio.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

A

Yeah. Today, it's in the 7-plus-percent sort of range as a percentage of total. And I think we'd expect it to stay there to grow potentially up modestly as a percentage of total. You might remember that now going back almost three years, we committed to trying to change the mix of business within investor real estate. In 2014, 85% of our production was construction, primarily of multi-family. And we began to work that level of production down. It had a significant impact on balances as you see and so our balances have significantly declined.

We did reach a point in the second quarter when we began to, I think it was in part because of seasoning began to have the opportunity to win a few more commercial mortgage opportunities. And those are typically going to be financing seasoned properties with stabilized cash flows, largely on multi-family office projects. We have some retail exposure, but most of what we're doing is multi-family office

and some industrial. And with that comes full relationship. So we pick up deposit balances, we pick up opportunities to generate fee income through our capital markets, secondary market offerings, placement products. And so, we think it's a business we want to grow sort of with the economy maybe plus a little as it provides a lot of ancillary opportunities. But again, it won't grow to be too much larger percentage of the total than it is today.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Great. Thank you.

Operator: Your final question comes from the line of Peter Winter with Wedbush Securities.

Peter J. Winter
Analyst, Wedbush Securities, Inc.

Q

Good morning. I just wanted to ask another question on expenses. You had a nice drop in expenses in the third quarter. Do you think they could drop a little bit more in the fourth quarter given the full quarter benefit of the head

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count reduction? And then looking at 2019, would you expect expenses to be kind of flat maybe even down a little just given a full year benefit of the lower head count?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, Peter. I think really focusing on improvements in the efficiency ratio is probably a better way to answer your question. We are making investments as I mentioned earlier to grow revenues, make investments in higher growth markets. We're trying to pay for that and keep our expenses relatively stable as we've mentioned for the year, which means we have to have reductions in other places to pay for those investments. So, we feel good about where we're going to end up for the year. Fourth quarter ought to be strong and we'll update you on 2019 – actually for the next three years in February.

Peter J. Winter
Analyst, Wedbush Securities, Inc.

Q

Okay. Thanks.

Operator: Thank you.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

Okay. Operator...

Operator: Thank you. And I'll will turn the call back over to John Turner for closing remark.

John M. Turner, Jr.
President & Chief Executive Officer, Regions Financial Corp.

Okay. Well, Thank you very much. We appreciate everyone's participation and thanks for your interest in Regions. Have a good day.

Operator: This concludes today's conference call, and you may now disconnect.

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